Equity Investments Notes for CMA US Exam

Overview

Equity investments represent ownership in entities, typically through **common stock** (voting rights, higher risk/reward) or **preferred stock** (fixed dividends, priority in liquidation, usually no voting rights). The accounting treatment depends on the **level of influence/control** and whether the securities have a **readily determinable fair value**. These notes, tailored for **CMA US Part 1, Section A.2**, cover key concepts, common vs. preferred stock, accounting methods, calculations, and exam tips, integrating insights from discussed questions.

Key Concepts

1. Common Stock vs. Preferred Stock

Feature	Common Stock	Preferred Stock
Ownership	Basic ownership with **voting rights**, enabling influence/control.	Preferential rights (fixed dividends, priority in liquidation), typically **no voting rights**.
Risk/Return	Higher risk (last in line for payouts); higher potential returns (capital gains).	Lower risk (fixed dividends); limited upside (less capital appreciation).
Dividends	Not guaranteed, paid after preferred dividends.	Fixed, paid before common dividends.
Special Features	May influence accounting method (equity method or consolidation).	May be **convertible** (to common stock) or **callable** (repurchasable by issuer).
Accounting	<20% ownership: Fair value method (if publicly traded). 20%–50%: Equity method. >50%: Consolidation.	Typically fair value method due to lack of voting rights, regardless of ownership %.

Exam Implication: Voting rights determine influence/control. Common stock can lead to equity method or consolidation; preferred stock usually uses fair value (Question 2).

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2. Levels of Influence and Accounting Methods

The accounting method depends on the **percentage of voting stock** owned and the degree of influence/control:

A. No Significant Influence (<20% ownership)

- **Accounting Method**: Fair Value Method (for securities with readily determinable fair value, e.g., publicly traded stocks).
- **Treatment**:
  - Record at **fair value**.
  - **Unrealized gains/losses**: Recognized in the **income statement**.
  - **Dividends**: Recorded as **investment revenue**.
- **Example (Question 4)**: Boggs, Inc. owns 30% of Mattly's common stock but lacks significant influence. Mattly pays $100,000 dividends. Boggs recognizes 30% × $100,000 = **$30,000** as investment revenue, ignoring Mattly's net income.

B. Significant Influence (20%–50% ownership)

- **Accounting Method**: Equity Method (common stock with voting rights).
- **Treatment**:
  - **Initial Recognition**: Record at **cost** (purchase price). Excess cost over fair value of net assets is **goodwill**.
  - **Adjustments**:
    - **Net Income**: Increase investment account by investor's share of investee's net income (recorded as **investment revenue**).
    - **Dividends**: Decrease investment account (not treated as revenue).
    - **Goodwill**: Not amortized; tested for **impairment** annually.
- **Key Formula**:

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Investment Account = Initial Cost + Share of Net Income – Dividends Received – Impairment (if any)

- **Example (Question 3)**: Boggs, Inc. buys 30% of Mattly's common stock for $700,000. Fair value of 30% of Mattly's net assets = $500,000; goodwill = $200,000. Mattly earns $300,000 net income and pays $100,000 dividends.
  - **Revenue**: 30% × $300,000 = **$90,000** (investment revenue).
  - **Investment Account**: $700,000 + $90,000 – (30% × $100,000) = **$760,000**.
  - **Goodwill**: Remains $200,000 unless impaired.

Item	Amount
Purchase Price (30%)	$700,000
Fair Value of 30% Net Assets	$500,000
Goodwill (Excess Cost)	$200,000
Investment Revenue (30% × $300,000)	$90,000
Dividends Received (30% × $100,000)	$30,000

Item	Amount
Ending Investment Account	$760,000

- **Why It Matters**: The equity method reflects the investee's economic performance, unlike the fair value method's focus on market value/dividends.
- **Misconception**: Goodwill is **fixed** at acquisition; it does not increase with investee performance (only adjusted for impairment).

C. Control (>50% ownership)

- **Accounting Method**: Consolidation Method (common stock with voting rights).
- **Treatment**: Consolidate investee's financial statements with the investor's, eliminating intercompany transactions.
- **Note**: Preferred stock, even with majority ownership, does not confer control unless voting rights are granted (Question 2).

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3. Preferred Stock Investments

- **Characteristics**: Fixed dividends, priority in liquidation, typically no voting rights (no significant influence/control).
- **Accounting (Question 2)**: Use **fair value method** if publicly traded. Changes in fair value and dividends impact the **income statement**.
- **Example**: A company holding preferred stock recognizes all fair value changes in net income, not OCI or retained earnings.

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4. Unrealized Gains and Losses

- **For Equity Securities with Readily Determinable Fair Values** (no significant influence):
  - **Unrealized gains/losses**: Recognized in the **income statement**, impacting net income immediately (IFRS 9, ASC 321) (Question 5).
  - **Not Deferred**: Unlike debt securities (e.g., available-for-sale), equity securities do not report gains/losses in OCI or defer until sale.

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5. Key Calculations

Equity Method (Common Stock)

- **Investment Revenue**: % Ownership × Investee's Net Income.
  - **Example (Question 3)**: Boggs, Inc.: 30% × $300,000 = **$90,000**.
- **Investment Account Adjustment**: Share of Net Income (increase) – Dividends Received (decrease).
  - **Example (Question 1)**: Best Billiard (40% ownership): $10,000 (income) – $15,000 (dividends) = **-$5,000** (net decrease).
    - New book value: $300,000 + $10,000 – $15,000 = **$295,000**.
  - **Example (Question 3)**: Boggs, Inc.: $700,000 + $90,000 – $30,000 = **$760,000**.

Fair Value Method (Common or Preferred Stock)

- **Investment Revenue**: % Ownership × Dividends Received.
  - **Example (Question 4)**: Boggs, Inc.: 30% × $100,000 = **$30,000**.

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6. Equity Method vs. Fair Value Method

Feature	Equity Method	Fair Value Method
Ownership	20%–50% (significant influence, common stock)	<20% or no significant influence (common/preferred stock)
Revenue Recognition	Share of net income	Dividends received
Unrealized Gains/Losses	Not applicable	Recognized in income statement
Goodwill Treatment	Not amortized; tested for impairment	Not applicable
Investment Account	Adjusted for income/dividends	Adjusted to fair value

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7. Additional Exam-Relevant Points

- **Goodwill (Equity Method)**: Excess cost over fair value of net assets (e.g., $200,000 in Question 3). Not amortized; tested for impairment annually.
- **Fair Value Option**: Rarely elected for equity method investments; requires justification (not commonly tested).
- **Impairment**: For non-publicly traded securities without readily determinable fair values, use cost method (adjusted for impairment/price changes), but irrelevant for publicly traded stocks.
- **Voting Rights**: Common stock enables influence/control; preferred stock's lack of voting rights restricts it to fair value method.

- **Threshold for Significant Influence (Question 6)**: Presumed at **20%** voting stock ownership, but consider other factors (e.g., board seats, policy influence).

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8. CMA Exam Tips

- **Memorize Ownership Thresholds**:
  - <20%: Fair value method (if publicly traded).
  - 20%–50%: Equity method (common stock, significant influence).
  - 50%: Consolidation (common stock, control).
- **Master Equity Method**:
  - Net income **increases** investment account and is recorded as revenue.
  - Dividends **decrease** investment account; not revenue.
- **Goodwill**:
  - Fixed at acquisition; only adjusted for impairment.
  - Does not increase with investee performance.
- **Fair Value Method**:
  - Unrealized gains/losses impact **income statement** (Question 5).
  - Revenue = dividends received (Question 4).
- **Stock Types**:
  - Common stock: Voting rights may lead to equity method/consolidation.
  - Preferred stock: Typically fair value due to no voting rights (Question 2).
- **Trick Questions**:
  - Dividends **do not** affect revenue under equity method (Questions 1, 3).
  - High ownership (e.g., 30%) doesn't always mean significant influence (Question 4).
  - Preferred stock uses fair value, not equity method (Question 2).
- **Practice Calculations**:
  - Investment revenue and account balance adjustments.
  - Net effect of income/dividends on investment account.
- **Use Past Questions**: Questions (52%–73% first-attempt correct rates) highlight pitfalls. Practice similar problems for accuracy.

Summary Table

Level of Influence	Ownership	Accounting Method	Revenue Recognition	Unrealized Gains/Losses	Key Example
No Significant Influence	<20%	Fair Value	Dividends Received	Income Statement	Question 4: $30,000 (dividends)
Significant Influence	20%–50%	Equity Method	Share of Net Income	Not Applicable	Question 3: $90,000 (net income)
Control	>50%	Consolidation	N/A (consolidated)	N/A	Not covered in questions

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*[**Fair Value Method**:*

- *Revenue = **Dividends received** ($30,000).*
- *Unrealized gains/losses (if fair value changes) go to the income statement,*
- *Ignores investee's net income for revenue purposes.*
- ***Fair Value Method** applies when **no significant influence** exists.*
- ***Dividends** = **investment revenue** (income statement). [Where It Goes - Income Statement]*
- ***Unrealized gains/losses** = **income statement impact**, not OCI. [Where It Goes - Income Statement]*
- ***Investment account** = adjusted to **fair value** at each reporting date.*
- ***Goodwill** is **not applicable** under the fair value method.*

Equity Method:

- *Investment Revenue = Share of net income (e.g., $90,000).*
- *Investment Account = Initial cost + Share of net income – Dividends received (e.g., $760,000).*
- *Dividends: Reduce the investment account; not treated as revenue or an expense.]*

Practice Tips for CMA Exam

1. **Focus on Differences**: Distinguish fair value vs. equity method based on ownership, voting rights, and influence.
2. **Memorize Formulas**: Master investment account adjustments and revenue calculations.
3. **Understand Stock Types**: Common stock drives influence/control; preferred stock uses fair value.

4. **Review Question Patterns**: Focus on adjustments, goodwill, and fair value recognition.
5. **Simulate Exam Conditions**: Practice timed numerical and conceptual questions to improve speed and accuracy.

These notes provide a concise, exam-focused guide to equity investments, emphasizing key concepts, calculations, and common pitfalls for the CMA US Exam. Practice with similar questions and review thresholds/formulas to ensure success.